4th Quarter Commentary

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Invisible Information

Let's say we wish to review the performance of our holdings this past year. Not the stock price returns—that's easy enough; that's a given figure. There's surprisingly little information in the portfolio return figure—it doesn't say much, other than how much share prices rose (or how much they didn't). It's possible for share prices to decline even as the earnings of the companies in a portfolio are rising robustly. In that case, is the portfolio down because other investors correctly perceive a peak in earnings and that share prices are too high relative to future earnings? If so, then other investors are correct and the portfolio manager is wrong. Or, what if earnings will continue to rise and valuations are low? Then other investors are wrong, perhaps distracted by other factors, and the portfolio manager is wiser, even if the portfolio is in temporary decline.

If one wished to review the *qualitative* performance of a portfolio and to assess how it might fare in the future, then one would have to examine its underlying constituents. A conventional measure might be average sales growth during the past year across the portfolio holdings, or earnings growth, or net profit margin. Like most broad measures of stock price valuation or performance, all of these sorts of metrics are easily produced in a pre-packaged format, as might be done on a Bloomberg terminal or with portfolio analysis software that is often provided gratis to brokerage firm clients. Such data is readily available to almost anyone. As well, such data is only superficially descriptive. And it's backward looking. It doesn't say much about how (or why) earnings or shareholders' equity might be higher or lower in the future. It's not predictive.

Also, the idea of assessing a varied set of companies via one or even several metrics, as if a portfolio of companies can all fit within a handful of pre-defined boxes, is a very limiting, unidimensional way to view businesses. It can miss a great deal of information content. What about all the data that has not been predefined and made available as individual fields in the databases that produce those ready-made reports? In a sense, for people who rely on those tools, that data doesn't even exist—and it might be very important. Availability error can be very costly. Each company might deserve a different type of metric, specific to its business model or transitory circumstance.

- Company A, for instance, has a high P/E ratio, considered appropriate because it is a well-regarded growth company with a fine balance sheet. Yet, implicit in its elevated share price is the expectation that revenues will continue to rise without slowing, much less interruption; that its profit margins won't narrow; that its very success won't induce regulators to examine its competitive position as to excessive market share or pricing power. The share price will be highly vulnerable to virtually any deviation from the historical and expected growth path.

- Company B also has a high P/E ratio, in fact identical to that of Company A, and they're both on the same security review list. It compares very poorly with Company A on the basis of sales growth, margin level, margin progression, and so forth. This is not a growth company. Rather, it is cyclical, albeit a very significant and well-positioned competitor in its industry. And its industry has undergone a deep recession. Accordingly, its revenues have declined, and its earnings have declined yet more. In a simple statistical comparison of Company A and Company B, the latter would not attract much interest.

However, Company B's high P/E simply reflects that its share price has not declined nearly as much as its earnings. One might have reasonable expectations that revenues and margins in this industry will eventually recover to their pre-decline level, likely even higher due to the increase in the population of the customer base during the intervening years. One might reasonably expect Company B to ultimately produce revenues and earnings well above the pre-decline level, because not only will its market be somewhat larger, but many weaker competitors have failed, leaving more of the industry pie for Company B and, as a bonus, perhaps reducing the amount of price competition. Perhaps this company is also repurchasing a large quantity of its shares, such that there will be yet more revenues and earnings on a per-share basis—or for each slice of the company's pie. In contrast to Company A, there is far less that can go wrong, and much more that can go right, very much of which might not be reflected in the price of the shares. This would fairly accurately describe the circumstances of AutoNation, a sizable position in a number of our equity strategies.

Here's a real-life example illustrating the potential problems with using standard metrics, based on a recent transaction that relates to the valuation of one of our holdings: Beijing Airport. It's an excellent example of an invisible metric that doesn't exist in the reality of the broader analytical community, because it hasn't been codified as such. Just a couple of months ago China's sovereign wealth fund agreed to acquire a stake in Heathrow Airport (which is private). It paid $727 million for a 10% interest, which suggests that—at least to that fund and to Ferrovial, the Spanish infrastructure company that then owned almost 50% of Heathrow—the entire business is worth about $7.27 billion. There are confirming arms-length transactions as well: last August, the sovereign wealth fund of Qatar agreed to buy a 20% stake in Heathrow for a price that implied a $7.0 billion value, and in 2010, a private equity firm purchased a 6% stake for an implied value of $7.3 billion.

Now for a view of the valuation of those prices based on the most popular standard metric: P/E ratio. That November price valued Heathrow at 26.5x estimated 2012 earnings. Four publicly traded major airport companies—Sydney Airport, Auckland Airport, Aeroports de Paris and Fraport AG, the company that manages the Frankfurt airport—trade at between 16x and 33.8x estimated 2012 earnings. The average of all five is 23.7x. Beijing Airport, of which we hold shares, is priced at 21.6x earnings. Nothing out of the ordinary. Everyone, in moments, can compare such pricing on a Bloomberg terminal. And what is a P/E anyway?

How about the Price to Sales ratio: Heathrow and Aeroports de Paris are both priced at 2.2x sales. Beijing: 3.2x sales. Expensive, yes?

Now let's look at a different measure of economic value, one that is applicable to perhaps only a few industries out of the scores or hundreds of industries that one might investigate. Heathrow is one of the busiest airports in the world—it had throughput of 88.5 million passengers in 2012. Aeroports de Paris saw a virtually identical number: 88.8 million passengers. We've learned that private investment capital values Heathrow at $7.3 billion; Aeroport de Paris has a stock market capitalization of $7.7 billion. So far, everything seems efficiently priced and consistent and comforting. But what if I told you that the Beijing Airport had 81.9 million passengers in 2012, right up there with the other two airports? And that Heathrow processed 3% fewer passengers in 2012 than 5 years earlier and that Aeroports de Paris processed only 3% more, but that Beijing Airport processed 53% more? It will be bigger than the other

two in a couple of years. And that Beijing Airport has a stock market capitalization of only $3.5 billion, less than one-half that of the other two?

At Horizon Kinetics, we use a different metric for Beijing Airport, one that has to be calculated by hand: Market Capitalization to Passenger Traffic, or what the scientifically inclined might wish to call the P/PT ratio. You can't pull up "passenger traffic" as a searchable variable on Yahoo! Finance. Heathrow is priced at $82 /passenger and Aeroports de Paris is $87. Beijing? Only $43. On this measure, Beijing would have to double to achieve valuation parity with these other major airports. Why doesn't Beijing yet manifest the same level of profits as the other two? There are reasons, but they are essentially temporary and developmental, related to the stage of growth at which the Beijing Airport finds itself. There are other valuation metrics that could be applied to this particular situation that would also suggest that this company is markedly undervalued.

A Different Metric

So here is an alternative metric by which to measure the progress of our portfolios during 2012. It measures people's or, rather, owner-operators' actions, not sales momentum, Enterprise Value/EBITDA ratios, or other standardized financial performance benchmarks. We believe there is qualitatively predictive information in this unconventional metric. These actions are the result of capital allocation decisions by business people who have their own capital at risk. These individuals don't necessarily share the same industry sector or financial market expertise. They might differ drastically with regard to political philosophies, assessments of the future direction of interest rates, the safety of the U.S. dollar, or virtually any other topic.

There is no reason to assume they share any concordance of opinion about anything except this: we suggest that it may be safely presumed that their primary goal with respect to their personal capital in the companies they control is to obtain what they believe to be an acceptable return on that capital for an acceptable level of risk. If one believes that such individuals have demonstrated the ability to achieve a comparatively high return on their capital over time, then their investment activity in one period should be predictive of their returns in subsequent periods. Following, in alphabetical order, is a review of this past year's capital allocation activity of many of the more significant holdings in some of our equity strategies.

- **AutoNation** repurchased 10.3% of its shares this past year through October 23rd. Moreover, Eddie Lampert controlled (through his hedge fund ESL Investments) 69.3 million shares as of November, now 56% of the total, up 3% from March 15th, the date of the last proxy statement. Since Mr. Lampert associated himself with AutoNation in the year 2000, the company has repurchased 65% of its shares, averaging 8.4% per year. This is most unusual in scale and duration; one is witnessing—or may participate in—a slow going-private transaction that is taking place in the open market. One implication of this program is that merely by the fact of automobile sales returning to a normalized historical level, the per-share results for AutoNation should be some multiples of its historical norm, all else equal.

- **Berkshire Hathaway** made its last significant business acquisition, the $8.7 billion purchase of Lubrizol, in September 2011. On the corporate finance front, though, that same month the company announced a share repurchase program, subject to a price limit no higher than a 10%

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premium over book value. Based on a description of the program and the Berkshire balance sheet at the time, the company might under the right conditions have repurchased up to about $10 billion of stock. It was the first time in its history that Berkshire would have repurchased shares. As part of this program, in December 2012, Berkshire acquired $1.2 billion worth of Class A shares from the estate of a long-time shareholder. It concurrently announced that it raised the clearing price for its stock repurchase plan to a limit of 120% of book value.

- **Colfax Corp**., an acquirer of certain industrial products companies, is 24% owned by Steven and Mitchell Rales. The Rales brothers also own 15% of Danaher Corp., which has a $40 billion market value and is likewise managed as an acquirer of varied industrial products companies. Ten years ago, in December 2002, Danaher stock, now about $58 per share, was $16.85; in 1990 it was only $0.98 per share. Had one held Danaher shares during the past 10 years, the return on investment would have been over 3.4x; over the past 22 years it would have been well over 59x. Colfax is a reprise of Danaher, but is at an earlier phase of its growth. As to capital allocation activity, in January 2012, Colfax acquired the U.K. firm Charter International, a manufacturer of industrial welding, cutting and automation, and air and gas handling equipment, for $2.6 billion. For a sense of scale, Colfax has a stock market capitalization of only $3.9 billion; the acquisition increased the Colfax revenue base by over 5x. In May 2012, Colfax paid $235 million for Soldex SA, a Latin America-based manufacturer of welding products.

- **DreamWorks Animation SKG** is controlled, on a voting basis, by Messrs. Spielberg, Katzenberg, and Geffen, who on an economic basis collectively own 22% of the shares. Until this year, the company's growing film library consisted exclusively of DreamWorks-produced animated movies. The company is also a persistent repurchaser of shares; since it initiated that program six years ago, it has acquired 28% of its then-outstanding shares. In 2012, two significant changes occurred. In February, DreamWorks announced a joint venture with China Media Capital to produce original Chinese animated and live action films. DreamWorks will own 45% of Oriental DreamWorks, which will be initially capitalized with $330 million. Considering the size of the Chinese market and the size of the initial investment relative to DreamWorks' $1.4 billion book value, this venture, if successful, could be quite significant to DreamWorks. In July, DreamWorks acquired Classic Media for $155 million. Classic Media owns the rights and intellectual property to titles such as Lassie, Casper the Friendly Ghost, and Where's Waldo?, which will be added to the DreamWorks film library. This is also a meaningful transaction, as it will increase the DreamWorks annual revenue by roughly 13%. DreamWorks trades at about book value.

Interjection: I'd like to return to the idea that these investors can have dramatically different, even diametrically opposed, views on the prospects for, say, the survival of the U.S. economy as we know it. Does that mean that such an investor who legitimately fears such an outcome will liquidate his or her investments— as is a common reflex among professional portfolio managers—and retreat to a fortified redoubt? Perhaps, but it hasn't happened recently, to our knowledge. But some who maintain such beliefs do alter their investment choices in order to hedge existing investments or even to profit from the outcome they fear. In this way, a pessimistic owner-operator can contribute true economic diversification to a portfolio. A case in point is Dundee Corp.:

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- **Dundee Corp.**, a Canadian company, has been quite successfully managed for over 20 years by Ned Goodman, who has voting control. The per-share book value is 4.5x higher today than 9 years ago. Dundee may be described as a portfolio company, analogous to Brookfield Asset Management or Leucadia National. Notably, though, Mr. Goodman is deeply and quite outspokenly concerned about the stability of the U.S. dollar, debt structure, interest rates, and other structural risks in the U.S. and Europe. Shareholder letters make frequent references to, for instance, Nassim Taleb[1] and black swan events.

  Yet, Mr. Goodman is a very active investor. In describing Dundee's capital allocation preferences, he is apt to say he is making investments that "continue to shelter its valuation from future global inflation…" Accordingly, Dundee focuses more on tangible resources, such as precious metals, real estate, agriculture (particularly the production of high quality protein for the future nutritional demands of Asian and Indian populations), and infrastructure. It manages assets for its own account and is a significant manager for other investors.

  In the year through September, Dundee repurchased roughly 14% of its shares and its Board approved an additional 3% or so. In February 2012, the company completed the acquisition of a publicly traded subsidiary, Dundee Capital Markets, making Dundee a fully-integrated investment bank and broker-dealer. It also initiated or increased investments in over 10 mining projects. And it has engaged in many more transactions than these, including a December 2012 announcement that it will distribute 50% of Dundee Realty shares to shareholders in a tax efficient restructuring of the company. The critical observation, though, is that Mr. Goodman's concerns about the risks he sees lead him not to liquidate or choose inaction but, rather, action—actions he believes will serve him better.

- **Howard Hughes Corp.,** in another indication of the degree to which management values its own equity, retired over 6 million long-term stock warrants that had been held by Blackstone Real Estate Partners, Fairholme Funds, and Brookfield Asset Management this past November and December. These transactions reduced the company's diluted share count by 9%, which had the effect of increasing per-share assets and earnings by 10%. The Blackstone and Fairholme warrants were exercisable at $50 and did not expire until 2017. The Howard Hughes share price in November and December was roughly $72, or about $22 above the exercise price, and the company paid about $30 to take back the warrants.

  More starkly, as a condition of their acceptance of the offices of CEO and President in late 2010, David Weinreb and Grant Herlitz entered into agreements to purchase seven-year warrants for $19 million, with an exercise price of $42.23, which was the trading price of the stock at the time. Further, the warrants were designed to be illiquid, being neither exercisable, nor sellable, nor hedgeable for five years. Essentially, if the stock were to be no higher after five years, they would lose $19 million, and would not earn a return on those warrants unless the shares would rise above $49. The CFO, Andrew Richardson, was hired somewhat later, purchasing about $2 million of warrants on the same terms but exercisable at $54.50. In the collective historical market knowledge

[1] Nassim Taleb is the author of *The Black Swan*, about unpredictable events.

of the analysts at Horizon Kinetics, there has never been a 'deficit' sign-on bonus like this—where one has to pay a king's ransom in order to take a job.

- **Jarden Corp.** conducted a Dutch tender auction for its shares in September 2012. Including other share repurchases, during the course of the year Jarden expended over $530 million, reducing its share count as of September by 12.6% compared to the prior year. It also eliminated its dividend. As a capital allocation decision, co-founders Martin Franklin and Ian Ashken, who own over $200 million of the shares and have effectively increased their ownership from 4.9% to 5.8% during the past year, appear to prefer that their business acquire more of its own equity than to pay out the earnings. If Wall Street consensus earnings estimates for next year are correct, the company's return on equity would be roughly 20%.

- **Leucadia National** announced, in November, its acquisition of the 71% of Jefferies Group, the investment banking/asset management company that it didn't already own. This is an interesting combination. Leucadia National's co-founders, Joseph Steinberg and Ian Cumming, are highly respected for the near-20% annualized compounding of per-share book value over the course of their company's 30-plus year history. They own 18% of the Leucadia shares, or about $1 billion worth. The Jefferies CEO, Richard Handler, controls 5% of Jefferies, currently worth somewhat under $200 million. When this transaction closes in the next few months, Jefferies will become Leucadia's largest business unit. Mr. Handler will become CEO of Leucadia, with Mr. Steinberg assuming the role of Chairman, and Mr. Cumming retiring from those positions, although remaining a director. Coincident with the announcement, Leucadia approved the repurchase of up to 10% of its shares.

  Despite its occupation, so to speak, near the vortex of the 2008/2009 financial markets crisis, since 2003 Jefferies has actually managed to provide an annualized *financial* return to shareholders—increase in per-share book value plus dividends—of over 12%. Leucadia trades below book value (actual and pro-forma), has a cash rich balance sheet, and substantial tax assets.

- **Liberty Media,** under the control of John Malone, who owns $1.25 billion of the stock, has been particularly active:

  - Liberty repurchased approximately $411 million of its Class A shares during the 12 months ended October 2012. Since March 2008, the company has repurchased over 45% of its Class A shares. Class A shares are the regular voting (1 vote each) shares, whereas most of Mr. Malone's are the Class B supervoting (10 votes each) shares.
  - Liberty also purchased over 650 million shares of SiriusXM Radio, for $1.4 billion. Combined with conversion rights, it raised its stake from 40% earlier in 2012 to 49.5% currently. Two weeks ago, Liberty received approval from the FCC to assume de jure control of SiriusXM.
  - Liberty will spin off all assets other than the Starz and Encore cable channels and related operations into an independently-traded company during the next few months. Following the transaction, Starz and its related assets will remain in the current entity, to be renamed Starz. The newly spun-off entity, which will include SiriusXM Radio, equity stakes in a variety of other companies, and cash, will be renamed Liberty Media.

- Liberty also purchased 9.5 million shares of Live Nation, raising its stake by about one-quarter, to 22%.

- **Limited Brands,** of which founder Leslie Wexner owns $2.4 billion of market value, continues to repurchase shares: $616 million in 2012, or about 3% of the total. Persistent, even if seemingly modest, annual share repurchases can produce remarkable results. During the past 9 years, Limited Brands has reduced its share count by 44%—earnings per share are at least 78% higher than they otherwise would have been, all else equal. There are ancillary benefits. A company that persistently reduces its share count can continue to raise its dividend even without expending more total dollars, since there are fewer shares upon which to pay; this, in turn, permits more profit retention for reinvestment in the business.

Interjection: To borrow a more familiar entity as an historical exhibit of the power of share repurchases, ExxonMobil has employed this approach for quite a long time. ExxonMobil is a mature company—in 2002 it produced 1.55 billion barrels of oil-equivalent (including natural gas); almost a decade later, in 2011, the figure, at 1.65 billion barrels, was barely different. That the company could replace that much production each year is remarkable, but it is not a growth company in the sense of being able to expand its business scope. However, ExxonMobil repurchased over 30% of its shares during the past decade, with the following results (from the end of 2003 to 2012): although revenues rose by only 7.1% per year, and net income by 6.0% per year—more or less the long-term average result for US corporate profit growth—per-share earnings rose by 10.6% per year,and the dividend was raised at a 13.6% annual rate.

We'll stop at the letter L. Although the examples above are a selection, not a comprehensive list, they are suggestive of some qualitative observations about the owner-operator companies in our portfolios. These companies were unusually active in acquiring assets and other businesses at deep discounts during, and in the aftermath of, the 2008/2009 financial crisis, while other companies were evacuating. We proposed that these were highly favorable investments, the true worth of which would only become manifest in earnings and book value growth in future years. Now, the attention of these owner-operators has also turned to the acquisition of their own stock, not only in larger quantities than one sees in the conventional publicly traded company, but even larger than has been their own historical practice. We suggest that this means something worth paying attention to.

What Did Other People Do in 2012?

Interest rates are about as important as any single factor can be in the financial markets. It is the basic, raw cost of money, against which almost all else is priced. And today we are in the Interest Rate Crisis era, because one cannot receive an adequate return on savings or safety capital. The U.S. bond market yields 1.5% for an average 6.4-year maturity (Barclay's U.S. Aggregate Bond Index). That is a largely taxable yield. It is a negative real return.

As to the direction of interest rates, we can say one thing with certainty: we don't know in which direction they will go, or when. We have our ideas, but we don't know. En masse, though, the general investing public seems to have made a prediction—rates are not rising by very much, very soon. This is what people did in 2012 (and for the 4 years prior): they fled, ran, leapt, dove—into bond funds, and out of actively managed funds into indexed funds:

($ billions)	Net New Cash Flows (through Nov.) 2012	2011
Mutual Funds		
Stock Mutual Funds	$(122.5)	$ (98.7)
Money Market Funds	(76.8)	(162.4)
Taxable Bond Funds	243.6	130.9
Municipal Bond Funds	52.7	(16.4)
Exchange-Traded Funds*	152.8	99.1

*For all ETFs; greater than 80% of which, by assets, are equity ETFs
Source: www.ICI.org

Based on the volumes of assets gathered by intermediate-term bond funds versus long-maturity funds, relatively fewer investors are so certain about interest rates over the next 20-30 years; however, a great many seem to have confidence worthy of a 5-10 year wager. It's a fairly big wager. To paraphrase the recent movie title: "There Might Be Blood."

One could elect to make a better composite wager by assigning that capital to better capital allocators: the owner-operators. One would have exposure to operating businesses, gold mines, real estate, and all manner of other assets. Unfortunately for the fixed income performance chasers, that exposure would be via equity investments; it's not a savings or fixed income allocation.

What Did We Do in 2012?

In a sense we, as principals of Horizon Kinetics, are owner-operators. We maintain a sizable and very liquid balance sheet ranging from short-term cash/working capital to long-term equity investments. We invest our capital because we also do not want to accept a negative real return on our funds and wish to receive an adequate yield, but we do not wish to take the price risk (or opportunity cost) of, say, a 5-year U.S. Treasury for the privilege of a 0.8% yield. As mentioned in a previous letter, in a world in which one cannot purchase yield, perhaps it needs to be manufactured. We have found, with our own capital, that it is possible to create yield, certainly at a much higher rate than is provided by the bond market, and with a suitably low degree of price volatility—at least to our taste—and have found ways to provide this in a fund format. The greater risk than a return to higher interest rates is reinvestment rate risk: a long, painful persistence of the current low level of interest rates. Under that circumstance, the shrinking number of higher-coupon bonds still owned eventually mature, not to be replaced. There is historical precedence for such a scenario. Accordingly, we wish to have alternatives.

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